Office of Chief Counsel
Internal Revenue Service

# memorandum

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KLGorman

date: SEP 26 2001

to: Joe Medved, Team Coordinator

from: Associate Area Counsel (LMSB:MCT) Philadelphia

subject: [redacted]

**Disclosure Statement**

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

This memorandum is in response to your proposed RAR and memorandum dated August 15, 2001. In those documents you request our opinion as to whether the partnership asset allocation rules of section 732 apply to your case. For the reasons set forth below, we do not believe they apply.

## FACTS

This memorandum should not be cited as precedent. The facts forming the basis of this advice are those provided to us as set forth below.

In [redacted] [redacted] Company ([redacted]) and [redacted] ([redacted]) and [redacted] ([redacted]) entered into a partnership agreement to provide dealer financing services for retail [redacted] and [redacted] sales of [redacted] Inc. The [redacted] companies owned [redacted]% and [redacted] owned [redacted]% of the partnership, named [redacted] Company. The partnership agreement provided that [redacted] could buy out [redacted], or [redacted] could force a buyout, after [redacted] years for an amount equal to [redacted]'s capital interest plus a percentage of the finance receivables, capped at varying amounts depending on the date. In [redacted], [redacted] merged into [redacted] leaving it and [redacted] as the only partners.

According to the asset purchase agreement, [redacted] ([redacted]), received by assignment [redacted]'s rights under the partnership agreement. On [redacted], [redacted] purchased [redacted]'s partnership interest. The purchase agreement specifies that [redacted] received by assignment all of [redacted]'s interest in the partnership and that [redacted] consented to the assignment.

Under the partnership agreement the formulaic preset price for the purchase amounted to $[redacted], while [redacted]'s tax basis was only $[redacted]. Thus [redacted] was paying a "premium" of $[redacted]. Roughly [redacted]% of the total book assets of the partnership was in finance receivables. The taxpayer treated the partnership as terminated on the date of purchase under 708(b)(1) and contributed all of the assets of the partnership to [redacted] Company LLC at an increased tax basis under section 732(b).

[redacted] allocated the lion share of the premium to the finance receivables. We are uncertain of the fair market value of the receivables, but it appears as though they may closely approximate book value. No amount was allocated to goodwill. Through allocating the premium to receivables [redacted] claims a write-off for the premium over one to three years. [redacted] attached a statement to its [redacted] return suggesting it was making an allocation of the purchase price of the assets over tax basis in accordance with 732(d), although this is clearly not what they did. During the examination [redacted] suggested that the attachment was a "typo" and that it meant to make the allocation under 732(c). Recently the taxpayer's outside counsel has suggested that the allocation be done outside of partnership allocation rules of section 732 and instead under fair market principles as any other asset.

In their written response the taxpayer's attorneys ignore the allocation rules of subchapter K. Their claim is that the allocation is governed by section 1012 and that the premium should be allocated among the assets based on fair market value. Since all the value of the assets is in the receivables, the taxpayer's argue their allocation must be respected.

<u>Agent's Position</u>

Your initial RAR took two positions. First, you asserted that under section 732(c) the basis must first be allocated to unrealized receivables and inventory items up to their adjusted bases and then to the other assets in proportion to their bases. The argument is premised on the contention that the receivables are "inventory items" under 751(d)(2) and thus all of the premium would go to the fixed assets which comprise 1% of total assets. This argument is derived from Rudd v. Commissioner, 79 T.C. 225. This would greatly extend the write off period. Taxpayer argues that they are not inventory items thus the proportional allocation must include the basis of the receivables.

The alternative argument that you raised is that the taxpayer elected 732(d) and is bound by that election. Under that theory the taxpayer must use 755 and 1060(d) to value the residual goodwill/going concern value. Under that method the excess premium, to the extent it exceeds fair market value, would be allocable to goodwill and subject to 15 year write-off under 197.

The RAR mentions Reg. 1.732-1(d)(4), which would require an allocation under subsection (d) if three requirements were met. The RAR did not assert that mandatory allocation was applicable.

Your August memorandum indicted that you no longer felt that the partnership allocation rules applied to your situation. You stated that, in accord with the taxpayer's attorney, you agreed that the basis of the assets is governed by section 1012.

CONCLUSION

We agree with your most recent memorandum that section 732 should not be applied in determining the basis of the assets acquired by [redacted]. Section 1060 governs the basis allocation.

The partnership ceased to exist on [redacted], therefore a technical termination occurred under section 708(b)(1)(A). It is currently our position that in such circumstances the purchasing partner is treated as buying the assets of the selling partner as if they were received in a liquidation. See McCauslan v. Commissioner, 45 T.C. 588 (1966) and Rev. Rul. 99-6, 1999-1 C.B. 432. We also have forwarded to you other portions of the Internal Revenue Bulletin that support this position. See 1999-1 C.B. 433 and Treas. Reg. § 1.1060-1. While technically the argument could be made that these rulings and the regulation are not applicable since they were not in effect until [redacted], we believe the correct result is to treat the [redacted] transaction consistent with the manner in which we currently would treat such transactions. (b)(5)(AC) [redacted]

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, (b)(5)(AC) [redacted]

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